

Before the
INTERSTATE COMMERCE COMMISSION

**Revenues of Rail Carriers in Official
Classification Territory
on Petition for Modification of Order**

Argument of
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of
Investment Bankers Association of America

Mr. Chairman and Gentlemen of the Commission.

After Government, State and important Municipal obligations Railroad securities have heretofore ranked next in desirability, and generally first in the business essential of convertibility. In consequence of this, from the Government down through the scale of material welfare, all classes are affected directly and seriously by the credit of Railroad securities, viz.:

The Government, Banks, Trust Companies, Insurance Companies, Charitable and Beneficial Institutions, Manufacturers, Individuals and Savings Funds, which all represent in their various uses and ramifications: Currency circulation; Protection of Depositors and Stockholders; Executors, Administrators and Guardians of Estates; Protection of Death and Accident Claims; Temporary investment of funds that would not otherwise be employed; Collateral value of loans in protection and expansion of trade, and for the protection of wage-earners' savings accounts. All classes are represented, and in the credit or discredit of Railroad securities all are affected as one.

Government and the Municipal securities mentioned occupy a distinctive class, have a distinctive privilege and have an added or artificial value, due to various uses, other than pure investment requirements, such as uses for National Banking purposes, security under certain Governmental requirements, exemption from taxation, and in certain States prescribed exclusively for so-called Legal Investments, all of which renders them generally prohibitive to the usual investor.

Railroad securities have few such privileges or inducements, and are subject to various taxation, according to the

laws of the Government and different States. Consequently the reason for investment in them is to secure a greater income yield and convertibility, which has heretofore been possible, and even at times profitable, but recent years have given the holders a descending scale of prices and a diminution of principal; a continuance of which seems to be confronting.

It is not within my province to dwell upon the indirect credit created by the development and diffusion of values, and the direct and indirect welfare of the entire population financially and otherwise, due to Railroad transportation, but it would seem to come within the scope of this argument to urge the recognition of the foreign money force heretofore brought to this country and employed through the Railroads in the development of our values and resources.

This source has been essential, and now being stopped on account of the War, and probably for a long time to be curtailed, in order to provide for the rehabilitation that will become necessary Abroad, we are menaced in two ways. First—being a debtor Nation with great necessary development beyond our own momentary resources, and Second—by the probability of the Foreign money markets requiring the cash value of our securities.

We cannot well overcome the First, but we may be able to a great extent to guard against the Second, by re-establishing the integrity of our Railroad credit, which would induce large numbers of foreign holders to withstand a desire to dispose of their holdings at this time, and so serve to help restore the equilibrium, which if destroyed would cause acute distress to this country and its people for a long time.

It is estimated that from \$4,000,000,000 to \$6,000,000,000 American Securities are held by foreign interests, the bulk of which are Railroad debts. Realization of these, due to existing conditions or disaffection, would be disastrous to an incalculable extent.

For all these reasons, which, voicing the investor, appear to be great, there is still another condition which predominates, and that is *the distrust of the investor in Railroad securities*, and this distrust, added to other conditions, makes it imperative that our National and individual duty should be to establish this credit beyond reproach or fear as far as may be within our power, as in my opinion this, while necessary before this prevailing War, becomes now vitally essential. While the weak only will attribute all their ills to this War (a condition too prevalent), it would not be the part of wisdom to neglect to study for our protection the probable portentous issues. Of the many lessons already taught us by the terrible conflict, a realization of the necessity to guard our fundamentals is foremost, and our National credit being involved, should show more clearly that credit among the individuals of a Nation is only magnified in the interweaving of credit between Nations.

Being to an extent intermediary between enterprise and capital, I have watched the distrust of the investor in Railroad securities with apprehension, bearing in mind the evil effect of unworthy floatation of securities, and have reached the conviction that without help and relief, the Railroads themselves, even under normal or prosperous times, will be unable to sufficiently augment their credit to be able to render their securities more necessarily desirable, and the granting of the Petition for Modification of Order appears to be requisite. I feel that if your Commission should decide that the full measures of relief petitioned for are equitable and just, that not only would Railroad and all other credits be in better repute and assume their proper place in the investment world, but the action would be the most important factor that could be adopted for the immediately necessary and continued improvement of commercial conditions, especially at this critical time, for the establishment of our domestic and foreign confidence.

The continued and growing distrust of the investor in Railroad securities is a condition that had not reached its

culmination when the present War crisis arose. The markets have evidenced it to the observer, and the dealer in securities has been compelled to exercise his best energy to combat it. It has not been a theory, but an entrenched fact. This distrust has caused the investor to be influenced in his choice by such liens as would undoubtedly withstand bankruptcy and drastic reorganization proceedings. On account of the seniority of such class of securities the supply is necessarily limited, and because of absorption have naturally maintained a fairly even level of value through varying conditions. They should not be much affected by present adverse conditions, or even if disaster should overtake the railroads. Consequently in speaking of railroad credit their value as a criterion should not be taken into account.

In subsequent issues for development or enlargement, even the most stable railroad systems cannot create liens of the same parallel or value, and the pressing problem begins at this point.

Discrimination in favor of reinforced liens as against good and secure, but junior securities, has so influenced the market that the Railroads have been compelled to meet immediate and pressing requirements by the issuance of temporary obligations in the form of short-time Notes and kindred obligations. These short-time debts are in amounts approximately :

Short-time Notes	\$410,325,000
Convertible Bonds	109,629,000
Receivers' Certificates	56,677,000
Total	\$576,631,000

maturing annually in the next few years to 1919.

These have heretofore been more or less currently marketable, according to the importance of the issuing Railroad systems, money market conditions, etc.

The investor, in purchasing this class of security, does so because he is willing to take a *risk for a short time, in*

which he feels he can trust his vision, and secure a high percentage basis yield of income. (These short-time obligations are mostly sold on a basis yield of income value, fluctuating with money market and other conditions.) The investor in such securities watches each phase of the general and railroad situation acutely, and is ready to sell at a moment's notice. This has been generally possible, as on account of the short maturity the relatively small fluctuation of a point (\$1 per \$100) or even several, makes a tremendous difference in the net yield without corresponding depletion in principal, and other investors of a speculative nature are attracted by the greater yield of a lower level with no more relative depreciation of his principal sum in event of his decision to throw them overboard.

For example :

Baltimore & Ohio—1-year $4\frac{1}{2}\%$ Notes, due June, 1915.

Issued June, 1914, at 100 & int..... $4\frac{1}{2}\%$ basis

Quoted July 30, 1914, at 98 & int..... $7\frac{1}{4}\%$ basis

New York Central—1-year 5% Notes, due Sept., 1914.

Issued Sept., 1913, at $99\frac{1}{2}$ & int..... $5\frac{1}{2}\%$ basis

Quoted Mar., 1914, $100\frac{3}{4}$ & int. (money basis)... $3\frac{1}{2}\%$ basis

Quoted July 30, 1914, $99\frac{1}{2}$ & int..... 12% basis

Recently extended for one year at 98 & int..... 7% basis

Southern Railway—3-year 5% Notes, due March, 1917.

Issued March, 1914, at $99\frac{1}{4}$ & int..... $5\frac{1}{4}\%$ basis

Quoted July 30, 1914, 97 & int..... $6\frac{1}{4}\%$ basis

This method of financing causes constant apprehension, as apart from the uncertainty of not knowing how, or by what means the obligations are to be met upon maturity, it is felt that the great bulk of temporary obligations put upon the market through the sheer necessity of the Railroads to complete or perform essential improvements, is fundamentally unsound in principle, and far more costly than would be the case if Railroad credits permitted of the financing of

long-time obligations, which sooner or later, in some way have to replace these debts. No earning capacity to the Railroads would be permitted that would allow of their retirement from earnings. Consequently these obligations constitute a menace to the stocks of even the best systems having such loans outstanding, and Railroad stocks cannot be recommended for investment purposes when such a profound floating debt must, through existing conditions, be maintained.

Railroad Equipment issues, payable in annual installments, secured by good equipment, with a reasonable initial cash equity, and backed by a reliable system, are in better repute, and sell at current market conditions at time of issue. But here again the investor is wary, choosing his maturity date, and basing his investment almost entirely upon the fact that in the history of Receiverships the United States Courts have usually sustained Equipment issues, on the ground that equipment is the superstructure essential to earning capacity, and so it is when there is traffic to move. This again tells the leaning of investors toward strict essentials.

Equipment issues maturing in the next five years to 1919, which should be retired from earnings of Railroads, aggregate approximately \$231,438,000.

In calculation of the extinguishment, extension or refunding of these various debts, as the case may be, to be arranged for in the best available way, according to conditions that may exist at the due time, investors are confronted further by the approaching maturity of heretofore issued mortgage bonds (as distinguished from the short-term bonds and notes previously mentioned), which approximately amount to **\$265,479,000**, due in the next five succeeding years to 1919.

We have, therefore, to meet between now and the close of 1919 maturing obligations aggregating **\$842,000,000**. New Railroad requirements, lowest estimate, **\$1,500,000,000**, making the great total of **\$2,342,000,000**

for which some form of security has to be found for capital. To this should be added **\$231,000,000** which should be provided from earnings to retire maturing Equipment Notes. I call your especial attention to the fact that approximately **\$500,000,000**, or about half of maturing obligations, fall due in 1915.

Even under normal conditions or ultra-prosperous times the burden would be great, and it cannot be lessened, but must be increased by the continued growth of the country and consequent demands for new capital requirements, of which I have accepted the lowest estimate of \$300,000,000, but which may require \$500,000,000 per annum for enlargements, extensions and improvements.

In your recent report you justly state:

“It is a matter of common knowledge that the revenues of railway companies are subject to fluctuations from year to year * * * periods of industrial activity, good business and high prices have been succeeded with some regularity by periods of inactivity, low prices and business depression * * * Each of the prosperous periods of 1903, 1907 and 1910 was followed by years of dullness and inactivity in business, and shortly after the commencement of this proceeding there began another period of depression, from which we appear now to be recovering.”

This would imply that an improvement in general business conditions, hoped to be approaching, would tend to restore Railroad prosperity (and more desirable credit) to an extent that would render an increase in freight rates unnecessary. The unhappy fact of the War need not be considered here, nullifying as it has all reasonable forecasts, but granting that commercial expansion would be accompanied with increases in gross earnings of Railroads, I earnestly maintain that the essential line of credit demarcation and confidence would still remain unchanged, as future prosperity would entail enlarged expenditures and future

recessions would find the Railroads with more to maintain and probably at a greater cost.

The contention that present and future conditions could be overcome by reducing or passing dividends, in order to conserve surplus accounts, seems to me to be more than dangerous, as the effect would be to still further discourage investment in bonds by injuring the value of stock equities. The bondholder's safeguards are surplus and stock equity, and his inspiration to confidence is a dividend record. Both should be maintained if at all possible, as no property can be considered stable or desirable that has not established, or has not reasonable expectation of so establishing its affairs. While it is true that a surplus account is created for the protection of the property, it can only be expected to cover a reasonable emergency, and not a long period of various adverse conditions.

The fact that demands full emphasis, is that independent of commercial activity or depression, the freight rates accorded the Railroads should be such as to permit them not only to maintain a sound and permanent basic line of credit, in order to hold continuous confidence in their various classes of securities, but to encourage new capital for future financing requirements, and this, I believe, can only be accomplished by ability to demonstrate the stability of Railroad properties under varying conditions and to enable the stocks of Railroads to become more desirable by an enhanced earning capacity. Many Railroads could then largely finance their requirements by sale of increased stock issues, or at least issues of convertible bonds, adding thereby additional equities to securities already outstanding, as well as increasing the value of the capital stocks issued and to be issued, and protecting themselves and the public in that way against times of ordinary business depression.

In your recent report you also justly observe:

“Investors in Railroad securities, like investors in other securities, must bear the consequences of dishonesty or inefficiency on the part of those selected to

manage the properties. No one could reasonably contend that the public should pay higher transportation rates because once prosperous properties—like the New Haven, the Chicago & Eastern Illinois, the Alton, the Frisco, or the Cincinnati, Hamilton and Dayton—may now be in need of additional funds as a consequence of mismanagement. Investors in Railroad securities must also take the risk of those errors of judgment which not infrequently attend even the careful management of enterprises conducted for profit. But they should otherwise be permitted to enjoy fully the profits which naturally flow, under a reasonable scale of rates, from the exercise of good judgment, integrity and efficiency in the management of such properties.”

There can be no possible contravention of this statement or its fair intent. All of us have suffered from unfortunate policies, errors of judgment and abuses, and the most prudent investment dealers have unwittingly dealt in securities that were not such as believed to be, and this to the injury of their resources and prestige. The unoffending Railroads have suffered and the investor most of all, but unfortunately the necessary cure and protection that the public and our legislators have sought has caused an inflammation that has branded the worthy with the unworthy, so that the general public has not discriminated, and as a class Railroad securities have been too generally condemned.

Errors of policy or judgment, which as you say “not infrequently attend even the careful management of enterprises conducted for profit” presents the ever fallible “human equation” and is a reasonable risk, but the mind of the investor should be disabused from confusing this with wilful exploitation for gain. It is an unhappy and deplorable fact that workers in all fields of human opportunity have among them engrafting imitators, and we know of no profession that is free of such, and this despite the drastic preventive laws peculiar to each abuse. But because we run the risk of being unrighteously deprived of some of our belongings, it would be an added hardship to have the value of such property diminished in order that the unrighteous

should not profit thereby. I feel that most investors would rather benefit under just preventive laws with opportunity of having the unrighteous apprehended, which at least would provide some means of recovery.

An investor's view of the history of Railroads might be summarized briefly in five phases and nineteen lines of classifications.

First Phase

A Railroad demanded under any conditions.

Money secured anywhere at any cost.

Industries established along lines through every effort.

Failures and re-organizations.

Second Phase

Creation and development of values.

Necessary enlargements, betterments and extensions.

New Industries established through success of original ventures.

Antagonisms due to discrimination, real or implied.

Third Phase

Prosperous era and possibilities of combinations.

Abuses by some combinations and manipulators.

Popular demand for supervision as corrective.

General establishment of scientific maintenance and operation.

Fourth Phase

Unforeseen increased cost of materials, supplies and wages.

Tremendous necessity for capital requirements.

Restrictive or disturbing legislation.

Loss in gross, increased cost, depreciated net earnings.

Fifth Phase

Depressed times, antagonism and distrust.

Necessity for restoration of confident and helpful conditions.

Unprecedented European Wars, curtailing all markets.

Under each line of this classification the sub-divisions could be dwelt upon indefinitely.

In view of the shocking abuses of certain railroads and financing methods, the difficulty that confronts you in arriving at the equation of exact justness is fully comprehended. The broad law that the innocent must suffer with the guilty seems too extreme to be applied to this situation generally, where the welfare of so much and so many is in the balance. No conscientious citizen would want to have such financial overloads as the Railroads you have named benefitted at the expense of the people, but no more would he desire to see commendable properties held back and investors suffer because of those evils.

In review of all this the question before you seems to present three principal sub-divisions:

1. Can the investing public be adequately safeguarded in what it now has?

2. Can the investing public be provided with adequate security for present and future railroad requirements?

3. Can these be accomplished in justice and in a way to maintain other interests, that will sustain and promote industrial enterprise?

On account of the magnitude of the Railroads and their ramifications into all fields of industry, they represent the ranking, or standard business credit. Credits of Utilities and Industrials, being junior, naturally rise with it, and with it fall, frequently to a greater extent.

As large amounts of capital will also be necessary for these latter, and new enterprise being more in such industries, their credit should be promoted by the conservation of railroad credit. In this connection the investment banker is primarily concerned with Railroad credit, but not necessarily with Railroad securities as his function is to be the medium of securing capital for all.

As you have said, the real railroad question, under existing conditions, is the just balancing of mutual rights between the investors who furnish facilities, and the consuming public which pays the rates, which becomes a problem of great national concern. In consideration of this important conclusion it should not be overlooked that many of the consumers and investors so designated, occupy both positions, either directly or indirectly, as I have endeavored to demonstrate, and even where they do not do so directly, their welfare derived from Railroads is so interwoven that it is almost impossible to disassociate one from the other.

The question now before you for determination is, in the magnitude of the interests involved, undoubtedly the most important that has ever been submitted to any tribunal. If determination of this question comes within the powers conferred upon you the decision will profoundly affect the prosperity of the great mass of the thrifty and industrious citizens of this country, many millions in number, who in some exceptional cases by their individual ownership of a bond or two, or of a few shares of stock, and in innumerable other cases by the ownership of policies of life insurance, or by deposit of the earnings of their labor in saving banks, are the real owners of the Railroad securities held in this country.

Respectfully submitted,

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